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The leader in real estate technology

January 16, 2009

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Jennifer J. Johnson, Secretary
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Robert E. Feldman, Executive Secretary
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Regulation Comments
Chief Counsel's Office
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Mary F. Rupp, Secretary of the Board
National Credit Union Administration
1775 Duke Street
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Re: **Proposed Interagency Appraisal and Evaluation Guidelines**

Agency	Docket ID
OCC	OCC-2008-0021
FRB	OP-1338
FDIC	Comments, Proposed Interagency Appraisal and Evaluation Guidelines
OTS	OTS-2008-0012
NCUA	Comments, Proposed Interagency Appraisal and Evaluation Guidelines

Dear Sir or Madam,

I am writing to provide our comments regarding the Agencies' Proposed Interagency Appraisal and Evaluation Guidelines (the "Guidelines") released for comment on November 19, 2008. While my company supports the fundamentals set out in the Guidelines, I believe that the Guidelines must further stress the crucial role of licensed and certified appraisers in helping to revive our battered commercial mortgage market. Enclosed is a copy of a la mode's comments on the Guidelines. We are hopeful that the final Guidelines will extend the concepts of appraiser primacy and independence throughout all related statutes and regulations, including the Truth-in-Lending Act ("TILA") and the Real Estate Settlement Procedures Act ("RESPA").

David P. Biggers, Chairman, 3705 W. Memorial Road, Building 402, Oklahoma City, OK 73134, (800) 900-4945
Jennifer L. Sides, Esq., General Counsel, 700 12th Street, N.W., Suite 700, Washington, DC 20005, (202) 250-3490

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a la mode, inc. is an industry leader in real estate transaction technology, developing and implementing computer software, workflow management systems and e-commerce technology for a wide range of participants in the residential real estate sales and mortgage lending arenas. Thus, we are very knowledgeable about the appraisal industry and how that industry serves as the sole independent party in the residential real estate mortgage transaction. a la mode is in regular contact with over 50,000 residential real estate appraisers and is uniquely situated to comment on the Guidelines. We appreciate your review of the enclosed materials and welcome you to contact our general counsel, Jennifer L. Sides, Esq. at (202) 250-3490, or me should you have any questions.

Sincerely,

DP Biggers

David P. Biggers
Chairman

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Enclosures
5323843_1.DOC

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COMMENTS TO THE PROPOSED INTERAGENCY APPRAISAL AND EVLUATION GUIDELINES

JANUARY 16, 2009

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COMMENTS TO THE PROPOSED INTERAGENCY APPRAISAL AND EVALUATION GUIDLINES

JANUARY 16, 2009

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I. EXECUTIVE SUMMARY

a la mode[1] hereby submits these comments in response to the Agencies' Proposed Interagency Appraisal and Evaluation Guidelines (the "Guidelines"), and in support of their effort to promulgate clear and comprehensive valuation guidance in the midst of dramatically debilitating uncertainty in the mortgage and financial markets. As requested by the Agencies, we are writing to offer our suggestions in order to ensure that the Guidelines encourage sound lending practices based upon reliable real estate collateral valuations. Specifically, we wish to (a) encourage the Agencies to establish the Guidelines as minimum requirements, impervious to abrogation by state action or private agreement; (b) highlight the dangers, including American job losses, posed by Automated Valuation Models ("AVMs") and third-party valuation service providers in the context of the current recession; (c) explain the critical role of licensed appraisers in correcting property values and stabilizing the economy; and (d) offer certain technical improvements to ensure the Guidelines achieve comprehensive valuation soundness and independence.

II. COMMENTS

A. The Guidelines must be established as minimum appraisal requirements.

In the same way that the Guidelines acknowledge the Uniform Standards of Professional Appraisal Practice ("USPAP") as the professional standard applicable to Federally Related Transactions, it is imperative that the Agencies implement the Guidelines as a baseline requirement governing the activities of all financial services institutions. Considering the widespread consensus that the current financial crisis was fueled by lax lending standards and inflated valuations, and given the tumultuous reorganization of the nation's financial institutions throughout 2008, it only makes sense that the Agencies should set a clear and sound path to market recovery and stability. Of course, financial services institutions shall be at liberty to impose additional requirements in consideration of their respective portfolio risk profiles and other relevant variables.

1. Government Sponsored Enterprises should not be exempt from the Guidelines.

Throughout the real estate boom of the current millennium Fannie Mae and Freddie Mac (collectively referred to herein as the "Government Sponsored

[1] Founded in 1985, a la mode, inc. has become the industry leader in real estate transaction technology by developing and implementing computer software, workflow management systems and e-commerce technology for a wide range of participants in the residential real estate sales and mortgage lending arenas. Privately held, a la mode, inc. is headquartered in Oklahoma City, Oklahoma, with offices in Salt Lake City, Orlando and Washington D.C.

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Enterprises" or "GSEs")[2] defined the mortgage-backed securities market and grew to own or guarantee approximately half of the $11.5 trillion in United States outstanding home loan debt.[3] However, as a result of a variety of woes *that are only beginning to be revealed and analyzed* the GSEs were forced into government conservatorship in September, 2008, have seen their stock value fall to below $1 per share,[4] and some speculate that they will be taken private or morphed into public utilities or federal agencies.[5] With such uncertain futures as a result of engaging in increasingly risky operating protocol[6] patterned after Wall Street profit motives,[7] coupled with their ongoing nature as shareholder-owned corporations,[8] it would be imprudent to empower the GSEs to further evade the safeguards established by the Agencies and effectively act as rulemaking governmental agencies.[9]

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[2] The Guidelines reference government sponsored agencies including Banks for Cooperatives, Federal Agriculture Mortgage Corporation, Federal Farm Credit Banks, Federal Home Loan Banks, Freddie Mac, Fannie Mae, Student Loan Marketing Association, and Tennessee Valley Authority. Although these comments focus on the GSEs in particular, we believe that all government agencies and government sponsored agencies should adhere to the Guidelines.

[3] CNNMoney.com, *Freddie Mac Mulls Reverse Stock Split*, Dec. 2, 2008, http://money.cnn.com/2008/12/02/news/companies/FNM_FRE_NYSE.ap/index.htm.

[4] *Id.*

[5] Alan Zibel, *Lawmakers Blast Former Fannie, Freddie Execs*, Yahoo! News, Dec. 9, 2008, http://news.yahoo.com/s/ap/20081209/ap_on_bi_ge/financial_meltdown/print; Press release, U. S. Department of the Treasury, Remarks by Treasury Secretary Henry M. Paulson, Jr. on The Role of the GSEs in Supporting the Housing Recovery before the Economic Club of Washington (Jan. 7, 2009); Associated Press, *Paulson Sees Changes for Freddie and Fannie*, N.Y. Times, Jan. 8, 2009. Additionally, it has been reported that the GSEs are considering waiving new appraisal requirements for refinancing transactions. *National Briefing, Mortgage Finance: Some Appraisals May Be Waived*, Washington Post, Dec. 11, 2008, at D02. Zachary A. Goldfarb, *Views Diverge on How to Recast Fannie, Freddie,* Washington Post, Dec. 22, 2008, at D01.

[6] Zibel, *supra* note 5. "Internal emails and other documents released by the House Oversight and Government Reform Committee show that former Fannie Mae CEO Daniel Mudd and former Freddie Mac CEO Richard Syron disregarded recommendations that they avoid riskier types of loans. Additionally, it appears that as Fannie Mae's appetite for Alt-A loans grew it "altered its underwriting standards by, for example, not running many of those loans through its Desktop Underwriter…system, an automated tool that helps lenders evaluate and price credit risk." *The Role of Fannie Mae & Freddie Mac in the Financial Crisis: Hearing Before the H. Oversight & Gov't Reform Comm.*, 110th Cong. (2008) (statement of Franklin D. Raines, Former Chief Executive Officer, Fannie Mae) [this hearing is hereinafter referred to as The Role of Fannie Mae].

[7] Zibel, *supra* note 5. Although the GSEs did not pioneer the subprime market they did follow Wall Street trends towards riskier, and potentially more lucrative, investments. (statement of Henry A. Waxman, Chairman, H. Oversight & Gov't Reform Comm.). In fact, in 2004 Freddie Mac's chief risk officer expressed concern that is was leading the market on no income/no asset ("NINA") loans. The Role of Fannie; *supra* note 6 (statement of Edward J. Pinto, Former Chief Credit Officer, Fannie Mae).

[8] Zibel, *supra* note 5. The Role of Fannie Mae, *supra* note 6. Further, even though the GSEs are now under the Federal Housing Finance Agency's conservatorship, consider that the Office of Federal Housing Enterprise Oversight did little to restrict the amount of credit risk taken on by the GSEs as they were expanding into the subprime and Alt-A markets. The Role of Fannie Mae; *supra* note 6 (statement of Franklin D. Raines, Former Chief Executive Officer, Fannie Mae).

[9] Letter from Office of the Comptroller of the Currency, Bd. of Governors of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Office of Thrift Supervision, & Nat'l Credit Union Admin. to James B. Lockhart III,

2. Neither states' attorneys general nor private parties should be permitted to distort or displace the Guidelines.

In early 2008 New York State Attorney General Cuomo presented his Home Value Protection Program and Cooperation Agreements involving Fannie Mae, Freddie Mac, and the Office of Federal Housing Enterprise Oversight, and the companion Home Valuation Code of Conduct ("HVCC"). Despite General Cuomo's laudable efforts to battle mortgage fraud and appraisal distortion, the HVCC encountered widespread criticism from private associations and federal regulators alike because it caused confusion resulting from its failure to mesh with existing federal regulations.[10] In fact, among the criticisms levied against the HVCC was a charge by the Agencies themselves that it "inappropriately attempts to regulate the corporate structure and internal operations of federally regulated lenders in connection with their mortgage lending operations" and presents "the type of federally-imposed requirements that should be subject to the full panoply of laws designed to protect the procedural and other rights of citizens and corporate entities from improper government action."[11]

Nevertheless, on December 23, 2008 the Federal Housing Finance Agency ("FHFA") announced a reincarnated HVCC which shall take effect on May 1, 2009.[12] Although the dramatically improved redraft of the HVCC evidences the FHFA's genuine consideration of feedback submitted during the comment period ending in April, 2008 (including extensive comments tendered by a la mode), we remain concerned (a) that the HVCC violates the Administrative Procedures Act, (b) that the FHFA will not have the opportunity to fine-tune the HVCC in the context of the final Guidelines, and (c) that the language of the HVCC requires technical revisions to ensure that the independence principles are comprehensively applied to all types of valuation products and services (see Section II.D.1 below for further discussion).

Director, Office of Fed. Hous. Enter. Oversight 4 (June 19, 2008). Note that Freddie Mac's former chief risk officer, David Andrukonis, "recognized that the GSEs played a crucial and unique role in the mortgage market through their ability to set market standards." The Role of Fannie Mae, *supra* note 6 (statement of Charles W. Calomiris, Henry Kaufman Professor of Financial Institutions, Columbia Business School). Additionally, the Agencies should consider how the GSEs' ability to alter appraisal standards will impact exemption #13 in the Guidelines (Transactions Involving Underwriting or Dealing in Mortgaged-backed Securities) to the extent securitized loan pools may have non-homogenous real estate collateral valuation underwriting characteristics that are not readily apparent to prospective investors. Proposed Interagency Appraisal and Evaluation Guidelines, 73 Fed. Reg. 69,647, 69,660 (Nov. 19, 2008).

[10] June 19, 2008 letter, *supra* note 9, at 1,2. Additionally, we note that certain provisions of the HVCC, as originally drafted, were so concerning that they attracted the attention of Congress. H.R. 3221, 110th Cong. (2d Sess. 2008).

[11] June 19, 2008 letter, *supra* note 9, at 2,4.

[12] Press release, Federal Housing Finance Agency, FHFA Announces Home Valuation Code of Conduct (Dec. 23, 2008)(http://www.fhfa.gov/webfiles/277/HVCC122308.pdf).

In any event, whether or not the HVCC is implemented on May 1, 2009 in the form in which it was released by the FHFA on December 23, 2008, it is important to acknowledge how quickly the market reacts to forthcoming regulations. Even before the original, proposed implementation date (January 1, 2009)[13] financial services institutions began changing their operating procedures to incorporate the use of Appraisal Management Companies ("<u>AMCs</u>"), which are third party service providers that coordinate appraisal services through established networks of independent appraisers in exchange for a service fee of 40% - 50% of the cost of the appraisal. Unfortunately, even the preliminary adjustment (that was based solely on the first draft of the HVCC and would be an unlikely consequence of the current draft, or any other species of the HVCC that is consistent with the Guidelines) has driven veteran appraisers from the workforce and, therefore, adversely impacted the quality of appraisals. In order to temper industry reaction to regulatory developments, and to ensure that the Guidelines are consistently applied throughout financial services institutions nationwide, the Agencies should be clear that no private party may enter into a contract effectively distorting or displacing the Guidelines.

B. <u>The Guidelines must discourage the use of valuation alternatives such as AVMs, especially those maintained by third party service providers.</u>

Although the mortgage industry has accepted AVMs for use as a "second opinion on the collateral value"[14] when coupled with an appraisal,[15] and has acknowledged that the "use of AVMs is becoming prevalent in the origination process in lieu of a full appraisal,"[16] "developing economic models and expanding databases used for AVMs is an ongoing process and may not have reached the point where AVMs are universally trusted."[17] Certain government agencies have recognized that the increased use of AVMs is a trend that warrants scrutiny.[18] According to Fannie Mae "the use of AVMs for loan origination purposes creates unique credit risks."[19] "AVMs have generally not evolved sufficiently to fully replace traditional appraisals and human

[13] June 19, 2008 letter, *supra* note 9, at 5.
[14] Leslie Albergo & Thomas Warrack, Standard & Poor's, S&P Focuses on Appraisals For Residential Properties and Encourages Use of Automated Valuation Methods (Jan. 23, 2008), http://www2.standardandpoors.com/prtal/site/sp/en/us/page.article/4,5,5,1,1148450907238.html.
[15] Mortgage Bankers Ass'n, Issue Paper, Automated Valuation Models 2-3 (2006); Freddie Mac, Bull. No. 2006-4, Single-Family Seller/Servicer Guide Bulletin 3 (2006).
[16] Suzanne Mistretta, Alla Sirotic & Margaret Sweeney, Fitch Ratings, Residential Mortgage Criteria Report: New Treatment of AVMs in U.S. RMBS 2 (2006).
[17] Office of Policy Dev. & Research, U.S. Dep't of Hous. & Urban Dev., Regulatory Impact Analysis & Initial Regulatory Flexibility Analysis: FR-5180-P-01 ch. 5, at 98.
[18] Nat'l Credit Union Admin., Credit Risk Management Guidance For Home Equity Lending 1 (2005).
[19] Interview with Mark T. Simpson, Director of Property Valuation Standards and Practices, Single-Family Credit Administration, Fannie Mae, Appraisal Buzz Newsl. (apprAZe.com, Mesa, Ariz.), Nov. 20, 2003, *available at* http://www.appraze.com/FNMAAVMs.

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judgment for the origination of first lien mortgages."[20] While we acknowledge that AVMs are utilized by certain lenders in limited capacities, and while we support the Agencies' efforts to address all current technology in the Guidelines, we feel we cannot overstate the danger posed by permitting the substitution of an unregulated technology such as AVMs as a replacement for the civil discourse and human interaction offered at a reasonable price by a licensed appraiser. Ironically, one of the suggested criteria for determining AVM use cited in the Guidelines is whether the AVM can recognize the subject property's address to ensure that it is evaluating the correct property.[21] How often can one imagine a financial services institution asking an appraiser, who typically gains access to the property with an agent of the lender/buyer and generates a photographic record of his work, "are you sure you had the right house?"

1. <u>AVMs are particularly dangerous in an unstable economy because they rely so heavily on raw market data.</u>

Although AVMs can be useful to financial services institutions in certain limited circumstances, such as portfolio reviews, the obvious shortcoming of AVMs is that they depend almost exclusively upon raw market data to generate a determination of collateral value. Because they are simply computer models they are unable to adjust valuation results for factors that a visual inspection of a subject property would quickly reveal.[22] Even in a stable market the "rough estimates" produced by AVMs can miss the mark significantly. However, in the severely depressed market in which these Guidelines must be effective, AVMs will be even less accurate because (a) the dearth of recent property sales requires AVMs to rely upon stale comparables or statistically insignificant sample sizes, (b) the few fresh comparables utilized will be from foreclosure sales, at artificially low prices, reflecting a paralyzed market rather than true value, and (c) the AVM valuation results will be impossible to validate due to unreliable inputs and inadequate sample sizes. Eventually, time will reveal the accuracy of AVMs operating in this mercurial market. Should we permit the mortgage loans constituting the rebuilding blocks of our economy to be the test cases for these unproven models?

2. <u>The outsourcing of AVMs introduces additional risk and will result in American job losses.</u>

In addition to the inherent risks posed by financial services institutions' use of in-house AVMs in lieu of traditional appraisals, the Agencies'

[20] eFannieMae.com, Automated Valuation Models (AVMs), https://www.efanniemae.com/sf/guides/ssg/relatedsellinginfo/avms/ (last visited Apr. 2, 2008); U.S. Dep't of Hous. & Urban Dev., Mortgagee Letter 2006-25 Regarding Home Equity Conversion Mortgage Program 3 (2006).
[21] Proposed Interagency Appraisal and Evaluation Guidelines, 73 Fed. Reg. 69,647, 69,661 (Nov. 19, 2008).[hereinafter referred to as Proposed Interagency]
[22] Even a so-called "drive by" appraisal, which would never be considered adequate to support a mortgage loan by any prudent underwriter, can be more effective than an AVM to identify certain patent deficiencies.

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contemplation of AVMs maintained by financial services institutions' affiliates and third party service providers presents a whole new set of concerns as the "black boxes" traditionally controlled by the financial services institutions' in-house valuation departments will now be under the control of parties that are detached from the direct ramifications of wantonly underwritten loans.[23] The variety and complexity of outsourced functions is evolving much faster than the market is capable of validating, and the ongoing woes facing domestic financial services institutions risk promoting discounted but unproven outsourcing options as irresistible alternatives when, in fact, they may not be appropriate subjects of outsourcing at all.

The most obvious species of outsourcing is when a financial services institution contracts with an unaffiliated third party to provide AVM services. However, an equally insidious form of outsourcing appears as overseas business process outsourcing ("BPO")[24] by international financial services institutions, which former Federal Reserve Board vice chairman Alan Binder speculates will put as many as 40 million American jobs at risk in the next 10-20 years.[25] Generally, BPO became popular to conduct relatively unskilled tasks but, according to Wharton's Peter Cappelli, these tasks are quickly evolving to include sophisticated, white-collar duties.[26] In connection with his work with Wharton's Mack Center for Technological Innovation, the University of Southern California's Ravi Aron described an outsourcing "knowledge continuum" that ranges from "data creation and validation work" to "working with information" and

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[23] The Agencies have acknowledged that "outsourcing critical business functions increases the risk inherent in those functions" and that "the use of a third party increases the need for oversight of the process from start to finish." Nat'l Credit Union Admin., Office of Examination & Ins., Supervisory Letter No. 07-01: Evaluating Third Party Relationships 9 (2007); Fed. Deposit Ins. Corp., Financial Institution Letter 44-2008: Guidance for Managing Third-Party Risk 3 (2008), *available at* http://www.fdic.gov/news/news/financial/2008/fil08044.html. Also, the Mortgage Bankers Association 2007 Technology Conference warned that outsourcing high risk "critical process[es]" can lead to "major consequences" upon failure. MBA Technology Conference, Offshoring Panel, Mortgage Bankers Association, Mar. 27, 2007, http://mortgagebankers.org/files/Conferences/2007/2007TechConference/8Srini.GDMOverviewofServices.pdf.

[24] Business process outsourcing, as discussed in these comments, should not be confused with the valuation alternative known as a Broker Price Opinion and commonly referred to by the acronym BPO. Additionally, it is important to understand the distinction between the terms "outsourcing" (which refers to functions allocated to an *outside* source) and "offshoring" (which refers to functions allocated to a *foreign* source). Throughout these comments the term "outsourcing" is used generically to describe a domestic financial services institution's allocation of certain business functions to an operator outside of its direct supervision, including the use of business process outsourcing.

[25] Knowledge@Wharton, As Citigroup Increases Its High-Skilled Headcount in India. Will Others Follow ? (Apr. 19, 2007), http://knowledge,wharton,upenn.edu/india/article.cfm?articleid=4187. A recent, general discussion of the increasing popularity of BPO among Wall Street financial services institutions can be found at Heather Timmons, *Cost-Cutting in New Yorkm but a Boom in India,* N.Y. Times.com, Aug. 12, 2008, http://www.nytimes.com/2008/08/12/business/12indiawall.html. [hereinafter referred to as Knowledge@Wharton]

[26] *Id.*

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finally to work that calls for "judgment, expertise, inference and interpretation."[27] The extensive Wharton study[28] revealed that managers in India, China and Singapore identified "number crunching, quantitative analysis, mathematical formulation, statistical data analysis and numerical calculations" as "low complexity work" while their U.S. and U.K. counterparts selected "persuasion, communication, context-sensitive responses, interpretation, subjective judgment and cultural sensitivity" as "low complexity work" for their employees.[29] The Wharton study included an analysis of an unnamed bank that suffered devastating outsourcing results because it neglected to acknowledge that certain functions are "embedded in the context of the market and they need context-sensitive communication." Although the bank was able to set up a "mirror image of Wall Street infrastructure…there is no turnkey of culture and context"[30] that can simulate a domestic operator's comprehension of marketplace nuances, let alone the safety and soundness offered by a licensed appraiser performing a thorough inspection of the subject property.

When financial services institutions rely upon overseas affiliates or unrelated third parties to develop AVMs those financial services institutions cannot fully understand how the models are constructed[31] (and, even though the Guidelines warn financial services institutions to avoid reliance on "value insurance or guarantees" offered by third party service providers,[32] the mere existence of such insurance products indicates the increased risk associated with the insured service[33]). Consider that Citigroup, a market leader in BPO, especially through Citigroup Global Services ("<u>CGSS</u>") which employed approximately 12,500 people in India,[34] recently sold CGSS to Tata Consultancy Services Ltd. ("<u>Tata</u>") for $505 million in an effort to raise capital for its faltering U.S. operations. Part of the agreement with Tata, a company with 40% of its business in the financial services sector,[35] was a 9.5-year, $2.5 billion contract for Tata to continue providing BPO services to Citigroup. What were once critical domestic business functions performed in-house by Citigroup employees are now the subject of a

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[27] *Id.*

[28] Ravi Aron, *Financial Services*, in Innovation in Global Industries: U.S. Firms Competing In A New World: Collected Studies, 341 (Jeffrey T. Macher & David C. Mowery, eds., 2008).

[29] Knowledge@Wharton, *supra* note 25.

[30] Knowledge@Wharton, *supra* note 25.

[31] The Comptroller of the Currency has acknowledged that "[v]endor models present banks with a trade-off between convenience and transparency." Office of the Comptroller of the Currency, OCC Bulletin 2000-16: Risk Modeling 6 (2000). The Agencies have also been clear that outsourcing does not relieve the contracting financial services institution from ensuring the safety and soundness of the third party services. *See e.g.*, Nat'l Credit Union Admin., Office of Examination & Ins., Supervisory Letter No. 07-01: Evaluating Third Party Relationships 6 (2007); Fed. Deposit Ins. Corp., Financial Institution Letter 44-2008: Guidance for Managing Third-Party Risk 1 (2008), *available at* http://www.fdic.gov/news/news/financial/2008/fil08044.html.

[32] Proposed Interagency, *supra* note 21.

[33] The Agencies should be wary of rebuilding the mortgage industry based upon an untested insurance scheme.

[34] Mary Hayes Weier, *Citigroup, Lehman Bros. Sell India Outsourcing Units*, InformationWeek.com, Oct. 8, 2008, http://www.informationweek.com/story/showArticle.jhtml?articleID=210800517.

[35] *Id.*

true third party outsourcing relationship with Tata, borne out of necessity, that will be integral to Citigroup's domestic business operations for the foreseeable future.[36]

3. <u>Third party relationships are difficult for financial services institutions to manage; outside AVMs are difficult to properly validate.</u>

Both the Guidelines as well as certain instructions promulgated by the Agencies concerning third party relationships require financial services institutions to validate the results produced by third party AVM providers (in much the same way as financial services institutions running in-house AVMs would be required to validate their own results).[37] Unfortunately, as a financial services institution becomes increasingly insulated from the valuation process its capacity to verify valuation results is diminished.[38] The Mortgage Bankers Association has noted that "there is little standardization in the AVM industry…[and] many lenders believe that AVMs entail a greater risk of inaccuracies" than appraisals.[39] Of course, it is no surprise that a wholly unregulated industry presents a wide range of disparities among its third party models, and it is simple to foresee that financial services institutions will have great difficulty satisfying their required cost-benefit efficiency analyses[40] while spending the time to (a) fully understand an outside AVM, (b) determine that the chosen outside vendor's unique model is an appropriate match for the financial services institution's asset portfolio profile,[41] and (c) evaluate the AVM's confidence score[42] to confirm that it is producing reliable results (especially considering the volatility of the inputs discussed above).

When financial services institutions outsource valuation functions in the context of third party AVM providers their in-house valuation departments inevitably will shrink. Accordingly, as economies of scale disappear it will be more likely that they will seek to outsource additional valuation functions, including increased

[36] Harichandan Arakali, *Citigroup Sells Back-Office Unit to Tata Consultancy (Update 2)*, Bloomberg.com, Oct. 8, 2008, http://www.bloomberg.com/apps/news?pid=20670001&refer=india&sid=arEyAzMytvyU. It is interesting to note that the Wharton study revealed that a majority of surveyed Fortune 1000 senior executives, mostly in the financial services industry, expressed a willingness to offshore product innovation (which Aron warns is a subject matter than does not translate well across cultures) and demonstrated particularly little concern for the ownership of the offshore provider (i.e., whether it is an affiliate or a true third party). Ravi Aron, *supra* note 28.

[37] Proposed Interagency, *supra* note 21. Office of the Comptroller of the Currency, OCC Bulletin 2000-16: Risk Modeling 3 (2000) [hereinafter referred to as Risk Modeling 3].

[38] Risk Modeling 3, *supra* 37.

[39] Mortgage Bankers Ass'n, Issue Paper, Automated Valuation Models 1 (2006).

[40] Fed. Deposit Ins. Corp., Financial Institution Letter 44-2008: Guidance for Managing Third-Party Risk 2 (2008), *available at* http://www.fdic.gov/news/news/financial/2008/fil08044.html.

[41] Proposed Interagency, *supra* note 21, at 69,647, 69,650 & 69,656.

[42] The Agencies have instructed financial services institutions to fully understand the confidence scores provided by outside valuation vendors, cautioning that confidence scores "come in many different formats and are calculated based on different scoring systems." Office of the Comptroller of the Currency, OCC Bulletin 2005-22: Home Equity Lending 5 (2005).

reliance upon AMCs to engage appraisers on their behalf. As discussed above, even the forecast of AMC prevalence has been disastrous to the appraisal industry. Additionally, certain AMCs also offer AVM services and financial services institutions utilizing AMCs will be inclined to subscribe to bundled AMC/AVM services.[43] Aside from the dangers inherent in outsourcing AVM services that must be considered by financial services institutions, a second variable, of which the financial services institutions may not be aware, is that the AMCs can turn around and outsource AVM orders to offshore BPO providers. Consequently, in addition to forfeiting more American jobs, the financial services institutions would need to spend the time and resources to understand and validate a second tier of outsourcing contracts and relationships (often with very limited access to the AMCs' offshore subcontractors, and very little comprehension of the multiple layers of unregulated programs facilitated and utilized by such parties). The Agencies should strive to implement all available safeguards to ensure that the financial services institutions remain engaged in the valuation process and accountable for the valuation results utilized by their underwriters, and that such valuation results constitute a reliable product based upon a recognized system of controls and validations.

C. Appraisals are the most reliable real estate collateral valuation option.

These tumultuous times only reinforce the basic consensus that a live, human appraisal is the most accurate method for real estate collateral valuation. Whereas AVMs frequently rely upon inadequate market data (that nobody has the opportunity to identify as inadequate until long after the loan transaction supported by the collateral valuation has closed), appraisals allow a skilled, licensed professional with intimate knowledge of the local market to (a) visually inspect the subject property, (b) assess the condition of the surrounding neighborhood, and (c) conduct a meaningful dialogue with consumers at the property as well as with financial services institutions during the underwriting process.

The Guidelines specifically remind financial services institutions that "to ensure that an appraisal is appropriate for the intended use, an institution should discuss its needs and expectations for the appraisal with the appraiser."[44] In every stage of the real estate collateral valuation process a certified appraiser can foster productive discourse among rational professionals whereas an AVM's "plug and chug" *modus operandi* eliminates the thoughtful examination necessary to correct and stabilize this

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[43] In fact, the efficiencies of bundled services make them popular throughout the mortgage industry. Consider, for example, Metavante's presentation at the Mortgage Bankers Association's Tech 08 conference advertising marketing, origination, servicing and default management services designed to "cover…the entire lifecycle of a loan." Dangelo & Associates, *Utilizing Global Sourcing Strategies to Excel in a Flat World. Survivability, Adaptability and Growth.* www.Innovative-Relevance.com, http://www.mortgagebankers.org/files/Conferences/2008/2008Technology/Tech08TodaysOutsourcingRealityPanel.pdf.

[44] Proposed Interagency, *supra* note 21, at 69,647, 69,661.

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country's battered financial markets. Furthermore, unlike an anonymous and unregulated AVM, a licensed appraiser permanently etches his name on every appraisal report he produces as a certification that his appraisal procedures and the resulting report comply with applicable Federal and State requirements. While the likely result of a faulty AVM valuation is simply a write-down by the unfortunate financial services institution, a misstated appraisal can threaten the appraiser with penalties including loss of licensure (and livelihood).

1. <u>Appraisals benefit financial services institutions and consumers.</u>

Although appraisals are incrementally more costly than AVM valuations, they provide a better result for financial services institutions and consumers alike. Financial services institutions can be confident that an appraiser will (a) identify needed repairs/improvements that distinguish a subject property from others in the neighborhood, (b) recognize local trends as harbingers of impending price adjustments, and (c) possess the common sense to investigate discrepant property characteristics that would not register with even the most sophisticated computer analyses.

Consumers are comforted by knowing that live, human appraisers are valuing their individual properties. Accordingly, the appraisers will be able to accurately value home improvements, and will be available to discuss property and neighborhood characteristics with the consumers and the financial services institutions after the initial appraisal is complete. Throughout 2008 many homeowners have been frustrated by financial services institutions' use of remote mechanisms, such as AVMs, to write-down the values of their homes and concomitantly reduce or eliminate their home equity lines of credit. Live appraisals give consumers confidence that a trained, licensed professional is available to engage each of them in an honest discussion concerning their home's value.

D. <u>Suggested revisions to the Guidelines.</u>

We would like to suggest the following technical amendments to the Guidelines to ensure that the ideals of appraisal independence and sound real estate collateral valuation are consistently realized among all valuation alternatives.

1. <u>All laws, rules, regulations, agreements and guidance seeking to augment or supplement the Guidelines must address all valuation alternatives equally.</u>

In light of the premature market response to the first draft of the HVCC (discussed in Section II.A.2 above) which, among other failures, proposed a devastatingly unbalanced playing field as applied among appraisers, AVMs and AMCs, we believe it is critically important to mandate that any future augmentation or supplement to the Guidelines by any public or private party (including the current

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HVCC) contemplate all valuation alternatives (e.g., appraisals, AVMs, AMCs, broker price opinions, etc.) to ensure that the new materials do not unintentionally or artificially marginalize the safety and soundness that appraisals contribute to the market as the superior valuation choice.

2. "Cascades" or "waterfalls" should never be permitted in connection with real estate collateral valuations supporting loan transactions.

Fitch Ratings has cautioned that AVMs can result in overvaluation through the use of "multiple cascades that allow a lender to shop for a value"[45] and it is clear that this abuse can occur both in-house at a financial services institution or in conjunction with an affiliated or third party service provider. The independence principles set forth in the Guidelines evidence a clear understanding of the dangers presented by commission-based loan originators improperly influencing valuation results. Permitting any valuation provider to select a collateral value from a menu of choices (whether this choice is made by an originator or someone allegedly independent from a financial services institution's loan production division) is an open invitation for that valuation provider to select a value based at least partially on whether or not it supports that closing of the transaction. Legitimate underwriting should be based upon the best available valuation produced by an independent party.

3. Valuation adjustments must be restricted and carefully documented.

The Guidelines appropriately provide for the replacement of valuations that "do not adequately support the opinion of market value."[46] However, the Guidelines should be augmented to provide that (a) before discarding an appraisal or transferring it to a new appraiser for adjustment, the underwriter shall contact the original appraiser to discuss unique property characteristics or concerns that contributed to the original valuation, (b) the underwriter shall keep copies of all collateral valuations in the loan file, together with detailed notes concerning deficiencies in discarded or amended valuations, and (c) absent a clearly documented change in the market or the profile of the loan applicant, a discarded appraisal shall never be replaced by an AVM.[47]

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[45] Mistretta, *supra* note 16. In fact, the Agencies have advised financial services institutions to implement policies and controls to preclude value shopping. OCC Bulletin 2005-22, *supra* note 42. The Guidelines support restrictions on cascading models as they provide that evaluation content "policies and procedures should address the process for selecting the most reliable evaluation method or tool for a transaction rather than using the method or tool that renders the highest value." Proposed Interagency Appraisal and Evaluation Guidelines, 73 Fed. Reg. 69,647, 69,655-69,656 (Nov. 19, 2008).
[46] Proposed Interagency, *supra* note 21, at 69,647, 69,657.
[47] This section, however, is not intended to limit financial services institutions from ordering subsequent valuations for validation or quality control purposes. June 19, 2008 letter, *supra* note 9, at 2.

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4. Financial services institutions' employees tasked with validating AVMs must be independent from the loan production staff.

The Guidelines provide that "persons who perform appraisals must be independent of the loan production and collection processes"[48] but they should also specify that any person validating an AVM should maintain similar independence.[49] Validation is a critical watchdog function and must be independent from all sources of influence.

5. Financial services institutions and consumers should be entitled to receive unmodified, unabridged copies of appraisals promptly upon completion.

The Guidelines should require that financial services institutions and consumers promptly receive unmodified, unabridged copies of all appraisals generated in connection with the underwriting of a mortgage loan, whether they are ordered by the financial services institutions directly or through an AMC. Financial services institutions will benefit from the opportunity to review all of the appraiser's notes (whereas some summary reports do not convey all of the appraiser's recorded observations).[50] Consumers will benefit from the chance to review the appraiser's original observations and conclusions, in addition to any adjustments that may be the product of (proper or improper) input by a financial services institution, AMC, or other interested party, such that the consumer will (a) be in the best position to digest unadulterated information about the subject property, and (b) act as a necessary watchdog over the valuation process.

Additionally, prompt delivery will permit the consumer to utilize a single appraisal to comparison shop among various financial services institutions for competing loan terms,[51] which is particularly important because if the consumer cannot do so the market will react in one of two ways; either (x) if the financial services institutions continue to require full appraisals, then a consumer will be required to pay for a new appraisal for each prospective lender, which undoubtedly will chill comparison shopping, or (y) financial services institutions will recognize that the only way to compete for consumers' business is to waive the appraisal requirement in favor of AVMs, in which case the best loan terms are likely to be supported by the most inflated valuations (which is exactly the pitfall the Guidelines seek to avoid).

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[48] Proposed Interagency, *supra* note 21, at 69,647, 69,652.

[49] Risk Modeling 3, *supra* note 37. Also, see the Comptroller of the Currency's bulletin regarding independence.

[50] Proposed Interagency, supra note 21, at 69,647, 69,655. "We note that the Guidelines expressly condemn certain abbreviated appraisal reporting formats, noting that "such reports will not be appropriate to support most federally related transactions."

[51] Proposed Interagency, *supra* note 21, at 69,647, 69,656. Note that the Guidelines provide for appraisal portability.